ALBANIAN FINANCIAL SYSTEM IN FRONT OF GLOBAL & FINANCIAL CRISIS - A NEW APPROACH TO ENSURE LONG-TERM SUSTAINABILITY

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Abstract

The intertwined global financial and economic crisis of 2008, unfolded the total exposure of the Albanian financial system in front of the systemic risk, by the Albanian banking system, as the absolute pillar of providing funding and intermediation in the economy. This cartel-like financing highway of the economy, developed by an oversized bank –based economy, could and practically downloads all the issues, pitfalls and inefficiencies of the banking system, on the shoulders of companies and individuals as borrowers, especially in times of economic contraction or crisis. This one-pillar financial system in Albania does not offer guarantees for a long-term sustainable economic development, which in turn, calls for a more balanced development of this system.

This paper proposes that, a more balanced financial system, subject to inter sectorial competition, with the presence of ever-developing nonbank pillar, the development of capital market and its respective long-term instruments and institutional investors, along with new areas of banking business (agriculture funding, private banking, etc.) could make a valuable contribution, not only to the sustained economic growth, increased competition, but also in alleviating the factors and premises, which ignited and energized the unprecedented global & financial crisis of 2008.

Key words: banking system, capital market, systemic risk, bonds, bad loans, financial crisis

1. Introduction

The Albanian economy and the financial system remained nearly unscathed form the last global economic and financial crises. Academic and professional discussions and arguments attribute this to "the traditional business model, based upon two strong principles: (1) ensuring simple financing structure, through clients' deposits and with a moderate use of leverage, and (2) offering plain vanilla products and services, away from sophisticated and crisis-generating products, which resulted as the most crisis-proof, management-effective and suitable model, for the actual phase of Albania's social and economic development. Also, this business model was placed into a conservative and stringent regulatory environment, continuously and strictly supervised by Bank of Albania"[394].

With a financial system almost dominated and identified with banks, as banking assets accounting for more than 95 percent of all financial assets and running a traditional banking model, it has practically absorbed all sorts of first-line shockwaves, generated by global economic & financial crisis, but it has brought to scene and materialized a special profile of systemic risk, in the form of bank-based systemic risk. But as the world and Europe is continuously coming out of the crises, the developments in the Albanian financial system, at least during the last three years, are rather mixed, rather than positive only. This brings into discussion the hot issue of ensuring long-term and sustainable economic growth, along with keeping and running the financial system in a stable and balanced way, with manageable risks.

By being indirectly integrated with global financial market and economy through the real economy and international trade network, was easily understandable that, initially Corporate Albania met with the economic shocks of global financial crisis quite tangentially. But as the first shockwaves of 2008 left Albanian economy quite intact, the aftershocks would be inevitable[395]. Global crisis shockwaves, would be materialized in the form of falling domestic consumption, either for durable or non-durable goods, dwindling liquidity, steady decline of remittances, as well as a slowing pace of investments in machines & equipment (see Exhibit 1 and Chart 1), which normally are intended to support an overall growing of business activity (mainly manufacturing and service sector).

2. A one-pillar albanian financial system and the need for developing a balanced system

The Albanian financial system is relatively new, developed mainly during nineteenth and twentieth centuries. Historically, it is based mostly in the banking sector, more than in the non-bank one.

The current architecture of the Albanian financial system provides a model, which continues to be deeply rooted in banking foundations, where the banking sector remains, unquestionably, at monopoly sector positions, in terms of providing financial services in the country. The banking sector pillar, has, within a relatively short period of time, been successful in providing a rapid, but careful development, by building his professional, financially sound and well capitalized profile, providing customer services and various banking products and financial, from the traditional ones, such as loans for business, housing and consumer, to electronic cards and e-banking.

The second pillar, of non-bank financial sector, is still in developing phase and at a pre-modern period, where the most striking absence is the active securities (stock) exchange. This dwarf profile is largely shaped by the narrow range of financial products and services and foremost, the modest level of development of the financial institutional infrastructure. Despite the presence of not-so-small-in-number non-bank financial companies[396], from leasing, insurance and private pension funds, the non-bank financial sector in Albania manages a dwarf percentage, if not negligible, of financial assets, nationwide (see Chart 2 and Exhibit 3). Typically, by Q2 2011, the Albanian banking system managed more than 94% of total financial assets total, whereas the rest was managed by non-bank financial

[394] MEKA, E., "In Brick & Mortar We Trust!", BANKIERI Magazine (3), AAB, April 2012, p.5.

[395] MEKA, E.: "Corporate Bonds - A New Way for Financing Corporates in Albania", ECONOMICUS, No.7, UET/PRESS, Fall 2011, p.33.

[396] The number of non-bank financial institutions (NBFIs) conducting their activity in Albania reached 17 in 2010. – Source: BANK OF ALBANIA: Supervision Annual Report, 2010, p.47.

institutions (NBFIs). As it can be seen, the financial intermediation by NBFIs continues to grow with anemic rates, as banks always thrive to increase their share in financial intermediation and the volume of financial assets under management. Their balance sheets are focused predominantly on short-term assets, thus reflecting the absence of long-term financial instruments, as well as the underdeveloped stage of securities market in Albania

In this architecture of the financial system and infrastructure, the only institution established as a theoretical framework, remains the Tirana Stock Exchange (TSE), initially designed to serve as an organized securities market in Albania. Even thou sixteen years have lapsed since its official opening back in 1996, it has failed to fulfill its natural mission, a typical securities exchange could provide: trading debt and equity securities. It used to operate a simple money market (primary and secondary T-Bills market) for the first three years; no more transactions recorded, hereafter.

The international experiences, by developed or developing countries, witness or point to the development of a relatively balanced financial system, despite the fact that, in developing countries the banking sector, plays a substantially major role and is a bigger foundation, supporting the economic development, as compared to the securities market and the non-bank sector. Theoretical disagreement exists, however, about the importance of stock markets for economic growth. Typically, there are some other differing academic views, which do stress that, "many transition economies have to focus on developing the basic infrastructure for a financial system"[397]. In this regard, "these countries should aim to develop their overall financial sector, starting with their banking systems. This will also be the most effective way to foster the development of small and medium-size enterprises, a key source of economic growth[398]. Generally, banks dominate the financial system in most developing countries, and the early stages of financial development, including that of securities markets, takes place through them. Because a bank is simultaneously a borrower, a lender, and a provider of payment services, it possesses a significant information advantage over specialized borrowers and lenders, particularly in a developing market where information is scarce[399]. In many developing economies, there are a few banks and these banks are large relative to the firms in the economy. Therefore, the credit needs of the business sector can be met by the banks, and there is no compelling reason for firms to turn to alternative sources of financing[400].

Logically, the economic development model, pursued by Albania follows the model employed by many developing countries, and it is essentially a model proposed by international organizations, such as the World Bank (WB), which has always and obviously emphasized the developing role of financial institutions and the banking system. Following this model for financial system development, the promotion and development of NBFIs was left unattended and in shadow, by focusing all energies on banking intermediation, thus neglecting the fact that, "the chronic problems of country and corporate overindebtedness have brought home the dangers of combining too much short-term debt with too little long-term equity"[401]. In this way, "the evolution of the bank-centered systems under government regulation have displayed major deficiencies. Past and current experiences have shown that most developing countries require greater variety in institutions and instruments than bank-centered financial systems allow".[402]

"Usually, financial development is measured by factors such as size, depth, access, and the efficiency and stability of a financial system, which includes its markets, intermediaries, range of assets, institutions, and regulations. The higher the degree of financial development, the wider the availability of financial services, that allow the diversification of risks. This increases the long-run growth trajectory of a country and ultimately improves the welfare and prosperity of producers and consumers with access to financial services".[403]

In this perspective, one important fact is that, the same attention must be given for the two pillars of the financial system (market), despite different contribution and commitment of national resources assets, those sectors provide to economic development. Banks, securities markets, and a range of other types of intermediary and ancillary financial firms all contribute to balanced financial development. A radical preference in favor either of markets or of banks cannot be justified by the extensive evidence now available. Instead, development of different segments of the financial system challenges the other segments to innovate, to improve quality and efficiency, and to lower prices. They also evolve symbiotically, with expansion of one segment frequently calling for an upgrade in others[404]. Practically, both bank and no-bank sectors offer different financial services to the general public, but quite complementing in their nature. The stock market liquidity and banking development both predict long-run growth, capital accumulation, and productivity improvements[405].

In this way, it remains quite imperative a shifting of the focus from intra sectorial competition, within the banking sector, to inter sectorial competition within financial system, i.e. between institutions that collect deposits on one hand, and non-bank financial institutions, on the other hand, as the only type of competition that ensures of a balanced and well-functioning financial system, as well as a sustainable economic growth.

[397] CLAESSENS, S., DJANKOV, S., and KLINGEBIEL, D.: "Stock Markets in Transition Economies", WORLD BANK, Finanical Sector Ducussion Paper, No.5 September, 2000, p.vi.

[398] CLAESSENS, S., DJANKOV, S., and KLINGEBIEL, D.: "Stock Markets in Transition Economies", WORLD BANK, Finanical Sector Ducussion Paper, No.5 September, 2000, p.vi.

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[402] SUDWEEKS, B.L.: "Equity Market Development in Developing Countries", PRAEGER, 1989, p.3.

[403] WORLD ECONOMIC FORUM – Financial Development Report p.4, 2011

[404] CAPRIO, G. and HONOHAN, P.: "Finance for Growth: Policy Choices in a Volatile World", World Bank Policy Research Working Paper, March 2001, p.3.

[405] Levine, Ross and Zervos, Sara: "Stock Markets, Banks, and Economic Growth", f.4.

3. Practical problems with the unbalanced financial system

The unbalanced financial system poses many risks, not only to the system itself, but also to a country's economic development. Theoretical and practical evidence show that, "the existence of several large financial institutions, within financial system is fairly counterproductive and leads to a non-competitive financial system[406]. This lack of inter sectorial competition between bank and nonbank sectors of the financial systems easily leads to increased cost of financing for the entire economy, especially for businesses.

"Also, the economy is at risk of crisis due to excessive reliance on bank lending. Because banks are highly leveraged institutions, the economy is much more vulnerable to a financial crisis than if more corporate borrowing had taken place in the bond market and the claims were held in well-diversified portfolios[407].

Additionally, banks can be obstacles to economic development in other ways. Despite attractive lending opportunities, and a tradition of commercial and industrial lending, a shortage of bank credit for the private sector develops and persists for years[408].

"In the case of Albanian financial system, which is almost entirely modeled around banks, has already concentrated all possible risks within banking system, thus contributing to establish a permanent systemic risk within it, with no way of possible diversifications on individual or market basis[409]". The impact of the last financial and economic crisis is the best witness how the oversized bank –based economy, could and practically downloads all the issues, pitfalls and inefficiencies of the banking system, on the shoulders of companies and individuals as borrowers, especially in times of economic contraction or crisis. Typically, the effects "the global financial crisis produced and marked on the Albanian economy and business could be summarized in two points: (1) an ever-increasing portfolio of problem loans, and (2) an en bloc tightening of credit conditions for all clients, by the banking system"[410]. Banks reacted by quickly decelerating lending and the credit to deposits ratio fell from 65% in 2009 to 58% in 2010 (see Chart 7). The dip in credit pace was more severe considering that in 2009 the deposits fell in absolute terms[411]. (2) The above mentioned increase in problem loans (see Exhibit 2 and Chart 7) clearly reveals a worsened business solvency, thus increasing the credit risk within the banking system and in the same time, triggered a simultaneous and automatic "protection" mechanism of the entire banking system, in the form of immediate tightening of lending terms and conditions by commercial banks, deleveraging and flying to security, by investing in government papers, thus acting as a simultaneous "cause and effect" mechanism.

"In the frame of the outbreak of global economic and financial crisis, this banking system's behavior was more than justified, but bringing this behavior in front of ongoing funding needs by Albanian economy and businesses, it ended up being a typical cartel-like financing behavior, since business financing is a quasi-exclusive domain of commercial banks, given the model under which, the Albanian financial system is developed and structured"[412]. In the absence of alternative competing funding channels, other than bank (loan) financing, Albanian businesses were faced with "mandatory" acceptance of tightened conditions, offered in a concerted way by all banks, as well as the limited bank loan offer, throughout 2009-2010 and even during 2011 (see Chart 5 and 6). "Therefore, businesses had no way out to raise capital and liquidity from sources, different in type and origin, with bank loans, which could have relaxed the impact of bank loans' tightened conditions and global financial crisis shockwaves on financial system and real economy, too"[413].

On the other hand, although the banking system in Albania absorbed the initial aftershocks of global financial crisis, its contribution in supporting the Albanian business weather the long-term international and domestic consequences of the crises has not been at full potential. Despite the fact that bank deposits has evidenced a sharp increase from 2009 and on, a substantial part of them are not channeled through Albanian economy, because banks have invested them abroad, by exporting valuable capital, in the form of placements and other portfolio investments (see Chart 3, 5 and 8).

Another problem with heavy reliance on banks is the sizeable "crowding-out" effect they caused with the financing of government debt (see Chart 4 and 6). "Attractive rates on government paper make the banks willing lenders to the government, to the exclusion of private borrowers. Typically, the high interest rates on government paper are due to large borrowing requirements that stem from recurrent deficits" [414]. This is quite true in Albania, as the yield of government papers has been always above the average rate of bank deposits. "The size and dominance of banks in the economy also gives them the market power to keep the risk premium on government bonds relatively high. The result is a risk-return profile for government bonds that is preferable to what can be achieved through lending to the private sector. In essence, banks begin to operate as bond mutual funds that take customer deposits and invest them in government securities. This is profitable since banks can earn a large income without the expense of credit analysis and credit risk management"[415].

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[407] HERRING, R., J., CHATUSRIPITAK, N.: "The Case of the Missing Market: The Bond Market and Why It Matters for Financial Development", The Wharton Financial Institutions Center, The Wharton School, University of Pennsylvania, Working Paper No.01-08, 2000, p.30, 39, 41, 55.

[408] CHAMI, R., FULLENKAMP, C., and SHARMA, S. : "A Framework for Financial Market Development", IMF Working Paper, WP/09/156, July 2009, p.49.

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[411] KADAREJA, A.: "Conservatism of Banks", BANKIERI Magazine (3), April 2012, p.7.

[412] MEKA, E.: "Corporate Bonds - A New Way for Financing Corporates in Albania", ECONOMICUS, No.7, UET/PRESS, Fall 2011, p.34.

[413] MEKA, E. & FILIPI, Gj.: "The Stock Exchange – A challenge still be undertaken. The Albanian Reality", ECONOMICUS Review (5), UET/PRESS, Spring 2010, p.85.

[414] CHAMI, R., FULLENKAMP, C., and SHARMA, S. : "A Framework for Financial Market Development", IMF Working Paper, WP/09/156, July 2009, p.49.

[415] CHAMI, R., FULLENKAMP, C., and SHARMA, S. : "A Framework for Financial Market Development", IMF Working Paper, WP/09/156, July 2009, p.49.

Alternatively, in the frame of sovereign debt crisis in Europe, Albanian banks seems to implement a gradual tacit derisk policy, by way of stabilizing and moderating, if not decereasing, their investment pace in Albanian government securities, especially by June 2012 (see Chart 4). This could create potential problems for the Government to satisfy its financing needs without increasing respective costs.

An issue, accompanying the lack of the capital market and furthermore, a balanced financial system is the liquidity provision. The link between liquidity and economic development arises because some high-return projects require a long-run commitment of capital, but (bank) savers do not like to relinquish control of their savings for long-periods.[416]

4. Advantages of developing the capital market and long-term instruments

The advantages of developing the capital market and introducing long-term instruments in the financial system are quite numerous and multifaceted. There so so many microeconomic, macroeconomic, as well as financial advantages, for all gropus of interest in the economy, and for the economy in itself. "The development of the capital market provides additional advantages and positive effects to the economy, as follows: (1) it allows competition between various instruments of a bank-centered system and the non-bank financial intermediaries, (2) investors have a greater range of risk and return opportunities, (3) it offers instruments that do not suffer from a cash-flow mismatch, and (4) it encourages the development of other financial market and instruments"[417]. Also, it contributes to financial deepening, which in turn supports a long-term economic development.

Many empirical results suggest that the financial drivers of economic growth have shifted from basic intermediation services supplied by the banking sector in the form of loans and deposits to more efficient and more sophisticated capital market services[418]. It should be noted that, institutional existence of the capital market in an economy cannot be conditional to by economic and financial crises, which inevitably erupt in certain moments within capitalism, but instead is driven by many major needs and the strategic factors, usually associated with:

- providing a sustainable economic growth;
- allocation of funding sources and securing long term financing for investments in the real
- economy, and a reduced the cost of capital for business;
- "liquidity,
- risk diversification,
- information acquisition about firms,
- corporate control, and
- savings mobilization[419];
- promoting flexibility and innovation in terms of using technology and financial instruments;
- facilitating the trading of financial instruments;
- facilitating the exchange of goods and services, etc.

By issuing stocks and bonds companies increase the allocating efficiency of savings, which then raises the returns realized. By maximizing returns on the part of investors, savings are stimulated and the supply of available funds is increased. Also, "advocates of the market-based system (i.e., non-banks) point to the fact that non-bank financial intermediaries are able to finance innovative and high-risk projects"[420].

Although, promoting competition from within the financial system may be a difficult undertaking, but it can be overcome by introducing new financial instruments and products, where the general public may invest. "Here, capital and money markets play a major role. The lower capital requirements and the greater importance of entrepreneurship relative to capital in nonbank financial institutions mean that two characteristics of the market are becoming visible – great number of participants and a greater ease of market entry"[421].

4.1 Corporate Bonds and Bond Market, as an intermediate phase towards balancing the system

As an immediate step toward developing capital market in Albania could be considered the establishment of the bond market, given its numerous advantages it provides to the financial system and the Albanian business, as follows: (1) "reducing the relative size and specific weight of the banking sector within financial system, thus reducing some negative effects, caused by quasi-absolute dominance of this sector, in terms of concentration of decision-making on crediting, creation of "crony capitalism", lack of all-time efficient administration of funds collected through deposits, and systemic risk (as previously mentioned), since banks are institutions with extensive use of financial leverage"[422].

Also, bonds could provide more investing alternatives for general public and other institutions, especially pension funds and insurance companies, by enabling them to design and offer long-term saving and investment schemes & products. Bonds are viewed as an opportunity for the investing public to diversify its savings on a wider range of investment alternatives, not only in the risk management perspective, but also in terms of channeling its savings into more productive investments, thus increasing social welfare.

Additionally, bond markets can constitute a transmission channel of monetary policy and perform an information function. "The presence of the bond market provides the economy with a market-determined term structure of interest

[416] LEVINE, R.: "Financial Development and Economic Growth – Views and Agenda", The WORLD BANK, Policy Research Working Paper. No.1678, October 1996, p.12.

[417] SUDWEEKS, B.L.: "Equity Market Development in Developing Countries", PRAEGER, 1989, p.5.

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[419] LEVINE, R., and ZERVOS, S., "Stock Market Development and Long-Run Growth", The World Bank, 1996, p10.

[420] WORLD ECONOMIC FORUM – Financial Development Report p.10, 2011

[421] SUDWEEKS, B.L.: "Equity Market Development in Developing Countries", PRAEGER, 1989, p.5.

[422] HAKANSSON, N. H.: "The Role of a Corporate Bond Market in an Economy-and in Avoiding Crises", 1999, p.4.

rates that accurately reflects the opportunity cost of funds at each maturity[423].

Finally, even banks could consider using corporate bonds as a new investment alternative and a bit different one from bank loan, as well as a good opportunity to yield some fees or offering value-added services for their clients in the securities market[424].

5. Conclusions

The paper aimed at addressing the issues associated with the non-diversified systemic risk, as an inherent endemic risk within Albanian financial system, caused by the monoline bank-based development approach, implemented since the fall of communism. The paper suggests, inter alia, the need to develop capital market and long-term instruments, especially corporate bonds.

The Albanian economy needs to ensure a sustained economic development, which calls for a more balanced and competitive development of its financial system, based on a two-pillar approach (bank and nonbank sector) and the presence of capital market and the development of long-term instruments.

It should be noted that, the systemic risk is the paramount of all risks, the Albanian banking system (and the whole financial system) has to address right now, following the oversized bank intermediation and quasi-inexistent private securities market (both equity and bond securities) in Albania. The prominence of this type of risk is always evident in periods of crisis in countries with significant bank-based systems. “The Asian crisis essentially demonstrated the systemic risk of an unbalanced financial structure, particularly with regard to an overreliance on bank credit and a lack of deep and liquid bond markets to supplement the banking system[425]”.

In the absence of bond markets, as part of capital markets, companies have to bear a big part of consequences deriving from the adjustment process, which usually follows any bank crisis situation, or complex situations within banking system, which heightens the systemic risk[426].

The landscape of the Albanian financial system obviously needs a professional mechanism, modeled as a multidimensional financial market profile, which can engage and stimulate all idle economic and financial capacities, within the national economy. The emergence and functioning of the full range of non-bank financial institutions, like: collective savings and long-term investment schemes (investment funds and pension), investment banking services and custody, brokerage houses and financial consulting, and above all, the functioning of TSE, will be the inflection point, in terms of ensuring a stable economic growth, increased competitiveness for the Albanian economy in regional terms and a greater stability within Albanian financial market. If we seek to ensure sustainable growth rates for the economy, away from systemic risks, we need to develop it on well-regulated and supervised institutional rails.

Conclusively, “suppressing a stock exchange or impeding its operation is a good way to reduce economic growth”[427].

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[425] EICHENGREEN, B. & LUENGNARUEMITCHAI, P.(2004), “Why Doesn’t Asia Have Bigger Bond Markets?”, NBER Working Paper No. 10576, JEL No. I20, J24, p.2.

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